Multistate US tax issues for inbound companies

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The authors give special thanks to Michael Santoro.

September 2013

This article was originally published by International Tax Review.

Foreign companies with activity in the US are often surprised that such activity may trigger both federal and state-level tax implications. Even more surprising is that state tax exposure may vary substantially, potentially resulting in significant state tax liabilities when little to no US federal tax obligations exist.

Foreign companies may not be used to dealing with tax authorities within a country that have such broad taxing powers. For example, states are not restricted in their taxing powers by federal limitations such as engaging in a trade or business, having a permanent establishment (PE), or treaty restrictions. States are also not bound by uniform tax laws; each state may implement unique tax rules, making compliance difficult for foreign companies.

There are several aspects of state taxation that are critical for owners of non-US companies to understand, including a state's power to tax, income apportionment, state filing methodologies, tax starting point issues, treatment of foreign source income, transfer pricing adjustment considerations, registration requirements, and indirect taxes.

Activities that could subject a foreign entity to state tax

A state's power to impose a tax is derived from the US Constitution and may be limited by: (1) the Commerce Clause of the Constitution; (2) the Due Process Clause of the Constitution; (3) federal statutes, such as Public Law (P.L.) 86-272; and (4) state law, such as 'doing business' statutes. US treaties generally do not apply to state taxation, unless specifically mentioned in the treaty or if a state voluntarily follows treaty provisions. A foreign entity should understand the various state theories that may apply to its activities that could subject it to state taxation.

A state may generally impose its tax on an entity to the extent a nexus, or taxable connection, exists between the entity and the state. Having a physical presence in a state will typically create such a nexus. While US federal taxation generally requires a threshold level of activity of being "engaged in a trade or business" or having a PE, a physical presence in a state is generally all that is needed for nexus to exist for state taxation purposes. Having employees or property in a state may be enough of a presence in a state to establish nexus. Thus, a foreign company may not have a PE, but it may have nexus and be subject to that state's taxes.

In addition to creating nexus through its physical presence within a state (for example, property or payroll), states may assert that a foreign corporation may have nexus through the in-state activities of an agent or affiliate. Additionally, some states have applied "economic nexus" or "factor presence" principles. Economic nexus could exist between a state and a company based on the presence of intangible property in a state. For example, the license of trademarks to a company in a state could create nexus for an out-of-state licensor on the basis that the intangibles are "present" in the state. A "factor presence" standard establishes nexus based on a certain level of sales activity into a state even in the absence of physical presence in the state. States such as California, Ohio, and Washington have enacted factor presence standards for certain taxes. California's factor presence statute, for example, provides that an entity is doing business with the state if the entity has more than $500,000 of California sales.

While economic nexus and factor presence concepts may be constitutionally suspect, until successfully challenged, they remain methods a state may use to bring foreign entities within its taxing jurisdiction.

One provision that may protect inbound companies is P.L. 86-272, under which a state is prohibited from imposing an income tax if the only business activity in the state is the solicitation of sales of tangible personal property, provided the orders are approved and shipped or delivered from outside the state. As the definition suggests, the protection only applies to income tax and the sale of tangible personal property. Service activities and other non-tangible property sales are not protected.

With broad nexus considerations, state nexus concepts appear to have a greater reach than US federal tax provisions when it comes to taxing non-US entities; however, there is one US federal tax requirement that does not apply to state taxation. A non-US entity that is neither engaged in a trade or business within the US, nor has a PE, may still be subject to withholding tax on US sourced income that is "fixed or determinable annual or periodical income" such as interest, dividends, or royalties. From a multistate tax perspective, the receipt of interest or dividends by themselves will generally not create nexus. The receipt of royalties will also generally not create nexus, unless such royalties are derived from in-state intangible property that is deemed to create presence in a state that has adopted an economic nexus rule.

Dividing up taxable income among states - multistate apportionment

Non-US entities may be familiar with the US federal tax concept of effectively connected income. That is, being taxed on income that is derived from a US business; however, for multistate tax purposes, a percentage of the entire net income of an entity (or group of entities, as discussed below) may be subject to tax by a state. That

This article was commission and originally published by International Tax Review.

The article appeared in serialized form on www.internationaltaxreview.com between August 7, 2013 and August 28, 2013.

percentage generally relates to the proportionate level of activity the entity has with the state as compared with its activity outside the state.

Activity may be measured by the relative in-state sales, property, payroll, or any combination of the three. Some states give greater weight to sales activity than property and payroll. A current trend among states is a move to a single-sales weighted apportionment factor. A single-sales factor results in states increasing their taxable reach among out-of-state taxpayers because the absence of in-state property and payroll does not serve to dilute the apportionment percentage assigned to the state as it would for a state that incorporates a property or payroll factor.

Complexities arise as states do not uniformly apportion income. For example, the assignment of service income to a particular state may be treated in various ways. Some states source service income to the location where the provider incurs the greater cost in performing the service. Other states employ a marketplace approach, sourcing to where the customer receives the benefit of the service.

Sales of tangible personal property are generally sourced to the state of destination. One exception applies to the extent a state has a throwback rule. Under throwback, sales are sourced to the state of origin if the taxpayer does not have nexus with the destination state or country.

The potential combination of a state asserting nexus based merely on a company having a certain threshold level of sales in a state, along with a single-sales factor apportionment regime and US treaties not binding the state, could result in substantial state income tax liability for an inbound company.

Tax filings include more than just the in-state entity

States vary regarding their treatment of reporting income among affiliates. 'Separate company' states require a taxpayer to report only the income of the taxable entity. 'Unitary combined' states may require a unitary group of corporations (which may be different from a US consolidated group, and which may include different members from state to state) to file as a combined group regardless of whether a particular entity has nexus with the state. This unitary group could consist only of US corporations (a water's-edge filing) or could include all global entities (a worldwide filing).

Generally, states giving taxpayers an option between water's-edge and worldwide provide worldwide filing as the default, like California, and taxpayers must elect to file water's-edge returns. In California, a water's edge election must be made on a timely-filed original return and is an 84-month commitment. A California water's edge combined report will generally include a foreign corporation to the extent of its effectively connected income (income derived from or attributable to sources within the US). Note California does not recognise provisions of US treaties. As such, to the extent they limit the application of effectively connected provisions of the Internal Revenue Code, California does not follow the limitations. Any controlled foreign corporation (CFC) – to the extent of its Subpart F income over its earnings and profits – is included in the California water's-edge combined report as well. Wisconsin has a similar rule regarding effectively connected income. Accordingly, the risk exists that a single entity's presence in a US state could bring the income of a global group of affiliated entities within the taxing power of the US state.

Additionally, composition of the group may vary among states. Some states may exclude 80/20 companies (generally, companies with 80% or more activity outside the US), and may define such companies in various ways. Other states may require certain taxpayers to be excluded from a reporting group based on their business. For example, a financial institution may be excluded from a reporting group because it either apportions its state taxable income in a fashion different from its other related affiliates or it is subject to tax on a different tax base such as gross receipts.

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Adjustments to federal taxable income starting point

The starting point for determining US state taxable income is generally an entity's federal taxable income. If an entity has no federal taxable income, does this mean that it has no state taxable income? Not necessarily. Some states may require an addback of a foreign corporation's income exempt from federal tax by treaty. Other states may require federal taxable income to be calculated on a *pro forma* basis as if a treaty did not apply.

Another discrepancy between US federal and US state taxable income arises from related party expenses. Certain expenses (such as royalties and interest) may be deductible for US federal tax purposes, but if such expenses are paid to a foreign or domestic related party, those expenses may have to be added back to taxable income for US state purposes. While most states have a foreign treaty exception to the addback, one must analyse the actual treaty as states may consider a US treaty that only calls for a lower tax rate different from a US treaty that exempts all the income from tax.

Treatment of foreign source income

While the treatment of foreign source income is technically an issue for US domestic entities, the complexities of how such income is treated should be of importance to non-US entities with federal and state tax reporting obligations.

For US federal tax purposes, domestic corporations receiving dividends from foreign affiliates are not allowed a dividends received deduction (DRD) as they would from a domestic subsidiary. Rather, the foreign dividends are included in taxable income and the taxpayer may receive a credit for foreign taxes paid. Some states may allow all or a portion of a deduction for dividends received from a foreign entity.

US shareholders of CFCs may be required to include a portion of the foreign entity's undistributed earnings in their federal taxable income. This deemed income is commonly referred to as Subpart F income. For state tax purposes, if the state starts with federal taxable income, the deemed dividend will be included in the state tax base. States differ on the extent to which the Subpart F deemed dividend and the Section 78 dividend gross up are subject to a DRD.

California employs unique rules for foreign source income. California requires that a water's-edge filer include a portion of certain CFC income and apportionment factors. The portion to be included is computed using a ratio of the CFC's Subpart F income to its total earnings and profits (its inclusion ratio). Additionally, dividends paid between unitary group members are eliminated to the extent the dividends are paid from previously taxed income. Finally, there is a 75% deduction for certain dividends not eliminated (that is, paid from excluded income).

States with transfer pricing adjustment power

Many states have IRC sec. 482-type powers to adjust the income or apportionment factors of taxpayers (known generally as UDITPA sec. 18 powers). States may force combined reporting on certain taxpayers regardless of whether intercompany transactions are at arm's length. Further, states may disallow interest expense to a foreign affiliate under their IRC sec. 482-type powers, even if the Internal Revenue Service has not adjusted that same payment. These are concerns for domestic and foreign companies alike; however, it may come as a surprise to non-US companies that US states have broad income adjustment powers that mirror federal powers.

Indirect tax considerations

State indirect taxation is generally any state tax that is not based on income. The most common indirect tax is a state's sales and use tax, but other indirect taxes include, for example, franchise taxes, real estate transfer taxes, telecommunications taxes, commercial rent taxes, and hotel occupancy taxes. The indirect taxes that apply depend

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on the nature of the company's business activities. A non-US company might be very surprised at the number of indirect taxes that it has to consider.

The nexus creating activities outlined in previous sections above apply generally to state income and franchise taxation. A non-US company's exposure to sales and use taxes differs slightly than that for income and franchise purposes in that a state is precluded from extending its sales and use tax obligations on an entity unless that entity has a physical presence in the state.

Concepts of economic nexus or an intangible presence are not relevant for sales and use tax purposes; however, states continue to push the bounds of what a 'physical' presence encompasses. Concepts of combined and consolidated reporting are also not relevant for sales tax purpose as each entity is a separate taxpayer for sales and use tax purposes. As a result, states are very aggressive on imposing agency or affiliate nexus as a means of bringing in out-of-state companies into their taxing jurisdiction.

In certain states, one of more recent trends is the establishment of nexus due to the use of affiliate marketers for out-of-state sellers. Affiliate marketing is an internet-based marketing practice whereby an in-state third party promotes the product or service of an out-of-state seller and the out-of-state seller compensates the in-state third party for such promotion. The in-state third party promotes the products or service of the out-of-state seller by providing a link on their website to the products and services offered by the out-of-state seller. Recently, affiliate marketing has been under scrutiny with certain states passing specific legislation that creates a rebuttable presumption that an out-of-state seller engaging in affiliate marketing with an in-state third party has nexus and is therefore required to collect sales tax.

As discussed above, one of the nexus protections for state income and franchise taxes is P.L. 86-272, but it does not apply to any non-income taxes. Accordingly, an entity with employees engaged only in the solicitation of tangible personal property within a state, which is otherwise protected from income tax nexus under P.L. 86-272, may still be subject to a state's sales and use tax and other non-income tax based taxes (i.e. franchise taxes based on net worth)

Once a company has nexus for sales and use taxes, that company is required to register with the state's tax department and file sales tax returns. Depending on the volume of sales, the company may be required to file returns on an annual, quarterly, or monthly basis. Generally, sales tax is imposed on retail sales, leases, rentals, barters, or exchanges of tangible personal property and certain enumerated services unless specifically exempted or excluded from tax. Sales tax generally is imposed in the jurisdiction in which the 'sale' occurs. The definition of 'sale' differs from jurisdiction to jurisdiction; however, the definition generally includes both: (1) consideration; and (2) transfer of title, right to use, or control (possession) in the case of tangible property and completion of the service act in the case of a service. All retail sales of tangible personal property are presumed to be taxable sales unless the contrary is established. When tangible personal property is sold, and the purchaser intends to resell the property, the sale is not a retail sale; rather, it is a sale for resale. A resale exemption is allowed because the intermediate sale does not represent the ultimate sale or final consumption sale of the tangible personal property. The burden of proving that a sale is not a sale at retail is on the seller unless an exemption applies. For example, the collection of a resale certification from purchasers generally supports the position that the sale is an exempt sale for resale.

Local taxation

New York City, New York; Portland, Oregon; and Detroit, Michigan are examples of cities that impose their own income tax modelled after their respective state's combined unitary reporting methodology. A non-US entity doing business in Kentucky or Ohio could find itself subject to dozens of individual city returns as many cities in those states impose separate income tax filing obligations. Compliance complexities multiply because US taxation geographies are further divided within states and some US cities have significant taxing powers.

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In addition, these and other cities impose local level sales and use taxes. Administratively, the sales taxes are usually collected and remitted to the state and then allocated to the localities. Generally, the rules for the localities are modelled after the rules for the states; however, this is not always the case. The rules can vary from jurisdiction to jurisdiction. Overall, there are thousands of indirect taxing jurisdictions in the US. Any non-US company doing business in the US should be aware of all the various indirect taxes that may be imposed.

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